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No. _____

IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1985

DANIEL A. TORRES, M.D., P.C., et al.,

Petitioners,

versus

HARRY V. EASTLICK, Trustee of North American Coin & Currency, Ltd.,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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QUESTIONS PRESENTED FOR REVIEW

I. WHETHER PROPERTY OBTAINED BY A DEBTOR'S CONSTRUCTIVE FRAUD BECOMES "PROPERTY OF THE ESTATE," PURSUANT TO 11 U.S.C. § 541, IN A SUBSEQUENT BANKRUPTCY PROCEEDING.

II. WHETHER, IN APPLYING STATE LAW TESTS FOR DETERMINING IF A CONSTRUCTIVE TRUST SHOULD BE IMPOSED ON PROPERTY WRONGFULLY OBTAINED, A FEDERAL COURT MUST CONSIDER ALL APPLICABLE STATE LAW.

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[1] *Pursuant to the provisions of Rule 21.1(b), Rules of the Supreme Court of the United States, the following is a list of all parties to the proceeding: *Petitioners: The Torres Class*, consisting of: Al C. Barney, James Bay, Victor Belkowski, Robert J. Bininger, Dan H. Brundidge, Todd Buffington, V. L. Byrd, Del Criger, Michael J. Desiderio, Joe Doe, Charles Estes, David Forshee, Anthony Furtadd, Nancy Gainer, Irvin Gamble, Jack Groat, Joell Haws, Jack Henriksen, Joe Johns, William N. Lafnear, John MacVean, Charles Mamana, Lloyd Mancl, D. D. Ragland, Mr. and Mrs. Bill Reeve, Nan C. Roach, Arthur Rose, Kathleen Rose, Paul and Betty Slosser, Tom Steinhelper, Swanson Enterprises, Daniel A. Torres, Linda Vance, Glen T. Walker, Timothy Walker, Jack E. Walsh, Kenneth A. White. *Respondent:* Harry V. Eastlick.

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HARRY V. EASTLICK, Trustee of North American Coin & Currency, Ltd.,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

Petitioners pray that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Ninth Circuit entered in these proceedings on August 6, 1985. Petitioners are a class of customers who dealt with a Chapter 11 debtor, North American Coin & Currency, Ltd., within ten days prior to the filing of its voluntary petition for reorganization pursuant to the Bankruptcy Reform Act of 1978 (hereinafter referred to as the "Bankruptcy Code"). Respondent is the debtor's court-appointed successor trustee.

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Ninth Circuit in *In re North American Coin & Currency, Ltd., Debtor (Daniel A. Torres, M.D., P.C., et al., Plaintiffs v. Harry V. Eastlick, et al., Defendants)*, is reported at 767 F.2d 1573 (App. A, *infra*). There was no opinion of the

United States District Court for the District of Arizona, which rendered its judgment February 8, 1984. It affirmed the July 25, 1983 judgment of the United States Bankruptcy Court.

JURISDICTION

The opinion of the United States Court of Appeals for the Ninth Circuit was entered on August 6, 1985. A Petition for Rehearing with Suggestion of Rehearing En Banc was denied on October 24, 1985. (App. B, *infra*). This petition for certiorari was timely filed. This Court's jurisdiction is invoked pursuant to 28 U.S.C. § 1254(1) (1982).

STATUTORY PROVISIONS INVOLVED

United States Code, Title 11: [1]

§ 541. Property of the estate.

(a) The commencement of a case under section 301, 302, or 303 of this title creates an estate. Such estate is comprised of all the following property, wherever located:

(1) Except as provided in subsections (b) and (c)(2) of this section, all legal or equitable interests of the debtor in property as of the commencement of the case.

(2) All interests of the debtor and the debtor's spouse in community property as of the commencement of the case that is—

(A) under the sole, equal, or joint management and control of the debtor; or

(B) liable for an allowable claim against the debtor, or for both an allowable claim against and an allowable claim against the debtor's spouse, to the extent that such interest is so liable.

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[1] The quoted statute has been amended. The subsections at issue, §§ 541(a) and (d), were not materially changed. The version cited herein is found at 11 U.S.C. § 541 (1982), and the amended version is found at 11 U.S.C.A. § 541 (Supp. 1985).

(3) Any interest in property that the trustee recovers under section 543, 550, 553, or 723 of this title.

(4) Any interest in property preserved for the benefit of or ordered transferred to the estate under section 510(c) or 551 of this title.

(5) An interest in property that would have been property of the estate if such interest had been an interest of the debtor on the date of the filing of the petition, and that the debtor acquires or becomes entitled to acquire within 180 days after such date—

(A) by bequest, devise, or inheritance;

(B) as a result of a property settlement agreement with debtor's spouse, or of an interlocutory or final divorce decree; or

(C) as beneficiary of a life insurance policy or of a death benefit plan.

(6) Proceeds, product, offspring, rents, and profits of or from property of the estate, except such as are earnings from services performed by an individual debtor after the commencement of the case.

(7) Any interest in property that the estate acquires after the commencement of the case.

(b) Property of the estate does not include any power that the debtor may exercise solely for the benefit of an entity other than the debtor.

(c)(1) Except as provided in paragraph (2) of this subsection, an interest of the debtor in property becomes property of the estate under subsection (a)(1), (a)(2), or (a)(5) of this section notwithstanding any provision—

(A) that restricts or conditions transfer of such interest by the debtor; or

(B) that is conditioned on the insolvency or financial condition of the debtor, on the commencement of a case under this title, or on the appointment of or taking possession by a trustee in a case under this title or a cus-

todian, and that effects or gives an option to effect a forfeiture, modification, or termination of the debtor's interest in property.

(2) A restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law is enforceable in a case under this title.

(d) Property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest, such as mortgage secured by real property, or an interest in such a mortgage, sold by the debtor but as to which the debtor retains legal title to service or supervise the servicing of such mortgage or interest, becomes property of the estate under subsection (a) of this section only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold.

(e) The estate shall have the benefit of any defense available to the debtor as against an entity other than the estate, including statutes of limitation, statutes of frauds, usury, and other personal defenses. A waiver of any such defense by the debtor after the commencement of the case does not bind the estate.

STATEMENT OF THE CASE

North American Coin & Currency, Ltd. (hereinafter referred to as "the debtor"), a precious metals broker, filed a voluntary Chapter 11 reorganization proceeding pursuant to 11 U.S.C. § 1101 (1982) *et seq.*, on September 23, 1982. Petitioners are customers of the debtor who placed orders with, and paid money to it between September 13-17, 1982. Respondent is the court-appointed trustee for the debtor. Petitioners' funds, which are the subject of the litigation, remain intact.

The Bankruptcy Court's jurisdiction over the debtor was conferred by the Bankruptcy Reform Act of 1978, Nov. 6, 1978, Pub.L. No. 95-598, § 241(a), 92 Stat. 2668 (then codi-

fied at 28 U.S.C.A. § 1471.) [2] The instant litigation, in which Petitioners sought the imposition of a constructive trust upon their pre-bankruptcy segregated funds, was a part of that case. Petitioners and Respondent filed cross-motions for summary judgment in the Bankruptcy Court, and it ruled in favor of the Respondent. An appeal was taken to the United States District Court for the District of Arizona, which affirmed the Bankruptcy Court's decision. An appeal was then taken to the United States Court of Appeals for the Ninth Circuit, pursuant to 28 U.S.C. § 1291 (1982). The Ninth Circuit affirmed the judgment of the District Court on August 6, 1985. A Petition for Rehearing With Suggestion of Rehearing En Banc was denied on October 24, 1985. This Petition has been filed pursuant to 28 U.S.C. § 1254(1) (1982).

Petitioners agree with the facts as set forth by the United States Court of Appeals for Ninth Circuit in its opinion. (App. A, A-2 through 9.) However, Petitioners do not agree that the facts support the conclusion that the debtor, in the ten days prior to the filing of its bankruptcy petition, was operating "in the normal course of business." (App. A at A-7.)

Indeed, the Court of Appeals for the Ninth Circuit found that the debtor, on September 12, 1982, was collectively and consciously perceived by the persons in control of the com-

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[2] That jurisdiction was declared unconstitutional in *Northern Pipeline Co. v. Marathon Pipe Line Co.*, 458 U.S. 50 (1982), but the instant bankruptcy case was filed during this Court's brief stay of its judgment. *Id.* at 88. That jurisdictional hiatus was subsequently cured by the Bankruptcy Amendments and Federal Judgeship Act of 1984, July 10, 1984, Pub.L. 98-353, 98 Stat. 343 ("BAFRA"), and amendments to 28 U.S.C.A. § 1334 (Supp. 1985). Since BAFRA only became effective on July 10, 1984, federal district courts continued to exercise jurisdiction over bankruptcy matters between the expiration of this Court's stay and BAFRA's enactment pursuant to former 28 U.S.C. §§ 1334 and 1471(a) and (b). *See, e.g., In re Kaiser*, 722 F.2d 1574, 1578 (2d Cir. 1983); *Matter of Braniff Airways, Inc.*, 700 F.2d 214 (5th Cir.), *cert. denied sub nom. American Airlines, Inc. v. Braniff Airways*, 461 U.S. 944 (1983).

pany to be "no longer operating soundly;" that said persons "expressed doubts about the company's continued existence as a going concern;" that they "chose to try to prevent the company from collapsing" by devising a scheme in which the company would appear to be normally transacting its business; that they "perceived ongoing mismanagement" by the president of the company which "was endangering the company's clients and employees;" that they implemented "an emergency plan," in order "to try to prevent the company from collapsing;" that, instead of using the new customers' monies to purchase the precious metals which they had ordered, consistent with its normal operation, from September 13, 1982 on, and without the customers' knowledge or consent, they caused such monies to be segregated in a newly-created "Special Trust Account" in the hope that by week's end the board of directors would vote "to keep the company alive" by the infusion of new capital, in which event Petitioners' money would be used to fill their orders, or, "in case the company did not survive," such customers "would get their money back." The company "closed its doors," and filed its Chapter 11 petition on September 23, 1982. Petitioners' monies, intact in the Special Trust Account, was neither refunded nor used to complete their orders. These facts unambiguously show the debtor's intention to obtain innocent customers' monies by holding out the appearance of a going concern, by not performing upon the representation that precious metals would be purchased for them, and by acting in a manner wholly inconsistent with the debtor's normal course of dealing.

The principals' plan, which was devised solely to prevent the company's immediate collapse, gave the appearance of a going concern during the five days prior to the directors' meeting, and falsely held out the appearance of a viable operation. The "Special Trust Account," which had been established for Petitioners' monies, was thereafter claimed to be "property of the estate" by the bankruptcy trustee, pursuant to the Bankruptcy Code, 11 U.S.C. § 541(a) (1982) and that assertion was upheld by the Ninth Circuit.

REASONS FOR GRANTING THE WRIT

Introduction

This case seeks to determine the issue of what constitutes "property" of a bankruptcy estate, 11 U.S.C. §§ 541(a) and (d) (1982). Since, by statute, "property of an estate" initially includes everything in which the debtor has a legal or an equitable interest, an analysis of that issue proceeds in reverse, and courts determine what property does *not* belong in an estate.

A determination of whether a bankruptcy court should impose the remedy of constructive trust upon property of an estate which is claimed to have been inequitably acquired is decided by reference to state law, to the extent that such law is not inconsistent with federal bankruptcy law or policy. Any reference to applicable state law must be thorough, "to the end that fraud will not prevail, that substance will not give way to form, that technical considerations will not prevent substantial justice from being done," *cf. Pepper v. Litton*, 308 U.S. 295, 305 (1939), and to aid in the constant examination of what constitutes the "outer boundaries" of property of a bankruptcy estate. *See United States v. Whiting Pools*, 462 U.S. 198, 205, n.10 (1983).

The United States Court of Appeals for the Ninth Circuit, by its failure to consider the *complete* law of fraud in Arizona, and its failure to apply that law to the inequitable conduct of the debtor, has rendered a decision which creates so strict a test for wrongdoing that future frauds will prevail, and, in so doing, has rendered a decision, purportedly turning upon state law, which is "clearly erroneous or unreasonable." *United States v. Durham Lumber Co.*, 363 U.S. 522, 527 (1960).

I. The decision below conflicts with federal law and applicable decisions of federal courts.

At issue in the instant case is whether established federal bankruptcy law and policy will condone a debtor's knowing misrepresentations and concealment, albeit benevolent in motive, of materially adverse facts, which thereby induces innocent parties to place money with it, to their detriment, and whether a succeeding bankruptcy trustee may utilize the monies thus obtained to benefit general creditors, by considering such funds to be "property of the estate" pursuant to 11 U.S.C. § 541(a)(1) (1982).

At the commencement of a bankruptcy case, an "estate" is created, which consists, *inter alia*, of all legal or equitable interests of the debtor in property as of the commencement of the case; property in which the debtor has only legal title, however, becomes part of the estate only to that extent, and any equitable interest in the property that the debtor does not hold does not become a part of the estate. *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 205, nn.8, 10 (1983); *Pearlman v. Reliance Ins. Co.*, 371 U.S. 132, 135-136 (1962); 11 U.S.C. § 541(a), (d) (1982).

As this Court noted in *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 205, nn.8, 10 (1983), property in which the debtor holds bare legal title, but not equitable title, becomes part of the estate only to the extent of legal title, and may not be utilized to enhance or enlarge the bankruptcy estate beyond that which the debtor held. Section 541(a)(1) does not expand the debtor's estate, and its trustee can succeed to no more or greater rights than the debtor held. *Richardson v. Shaw*, 209 U.S. 365, 378 (1908). "Congress plainly excluded property of others held by the debtor in trust at the time of the filing of the petition." *Whiting Pools, supra* n.10 at 205; *see also In re N.S. Garrott & Sons*, 772 F.2d 462, 465-66 (8th Cir. 1985); *In re Professional Air Traffic Controllers Organization*, 724 F.2d 205, 207 n.10 (D.C. Cir. 1984); *In re Auto-Train Corp.*, ____ F. Supp. ____, 53 B.R. 990, 994-995 (D.D.C. 1985).

Fundamental to federal bankruptcy law is the principle that a bankruptcy trustee, who represents general creditors of the estate, may not profit from the wrongdoing of a debtor. *Gorman v. Littlefield*, 229 U.S. 19, 25 (1913); *Richardson v. Shaw*, 209 U.S. 365 (1908); *In re Flight Transp. Corp. Securities Litigation*, 730 F.2d 1128, 1136 (8th Cir. 1984), *cert. denied sub nom. Reavis & McGrath v. Antinore*, ____ U.S. ____, 105 S. Ct. 1169, 84 L.Ed.2d 320 (1985); *In re Teltronics, Ltd.*, 649 F.2d 1236, 1239 (7th Cir. 1981); *Matter of Paragon Securities Co.*, 589 F.2d 1240, 1242 (3rd Cir. 1978); *Nicklaus v. Bank of Russellville*, 336 F.2d 144, 146 (8th Cir. 1964); *Gordon v. Spalding*, 268 F.2d 327 (5th Cir. 1959); *In re Liebig*, 255 F. 458, 463-64 (2d Cir. 1918).

Where an estate's property has been received through circumstances which make it inequitable that it should be retained by the one who holds only the legal title, courts will impose a constructive trust upon such property for the benefit of the true owner. *In re N.S. Garrott & Sons*, 772 F.2d 462, 467 (8th Cir. 1985); *Gordon v. Spalding*, 268 F.2d 327 (5th Cir. 1959); *In re Auto-Train Corp.*, ____ F. Supp. ____, 53 B.R. 990 (D.D.C. 1985); *In re Shapiro Brothers*, 298 F. 196 (S.D.N.Y. 1923) (Learned Hand, J.), *aff'd mem.*, 298 F. 1021 (2d Cir. 1924); *In re Shepard*, 29 B.R. 928, 931-932 (Bankr. D. Fla. 1983); *In re Vermont Real Estate Inv. Trust*, 25 B.R. 813 (Bankr. D. Vt. 1982); *In re Bengal Trading Corp.*, 12 B.R. 695 (Bankr. S.D. Fla. 1981); *see also Beatty v. Guggenheim Exploration Co.*, 225 N.Y. 380, 122 N.E. 378, 380 (1919) (Cardozo, J.).

Property obtained by fraud of the bankrupt, or by other tort is not properly a part of the assets of the bankruptcy estate. *In re Flight Transp. Corp. Securities Litigation*, 730 F.2d 1128, 1136 (8th Cir. 1984), *cert. denied sub nom. Reavis & McGrath v. Antinore*, ____ U.S. ____, 105 S. Ct. 1169, 84 L.Ed.2d 320 (1985); *see, generally* H.R. REP. No. 595, 95th Cong., 1st Sess. 367-8 (1977); S. REP. No. 989, 95th Cong., 2d Sess. 82-3 (1978); *see also* 4 COLLIER ON BANK-

RUPTCY, ¶ 541.01, at 541-6 (15th ed. 1985); *see* 11 U.S.C. § 541(d) (1982).

A debtor's interest in property is determined by looking to state law. *See, Butner v. United States*, 440 U.S. 48, 55 (1979); 4 COLLIER ON BANKRUPTCY, ¶ 541.02, at 541-10 (15th ed. 1985). Whether a constructive trust will be impressed thereon is also a question to be decided by reference to state law, although the ultimate issue of whether the property belongs to the bankruptcy estate is a federal question. *In re N. S. Garrott & Sons*, 772 F. 2d 462, 467 (8th Cir. 1985); *Matter of Quality Holstein Leasing*, 752 F.2d 1009, 1013 (5th Cir. 1985); *State of Texas v. Wellington Resources Corp.*, 706 F.2d 533, 536 (5th Cir. 1983); *Matter of Esgro, Inc.*, 645 F.2d 794, 797 (9th Cir. 1981); *In re American Intern. Airways, Inc.*, 44 B.R. 143 (Bankr. E.D. Pa. 1984); *In re Martin Fein & Co., Inc.*, 43 B.R. 623 (Bankr. S.D.N.Y. 1984); *In re Wyatt*, 6 B.R. 947 (Bankr. E.D.N.Y. 1980).

The Ninth Circuit's opinion in the instant case conflicts with these established principles of federal law by its failure to fully consider applicable state law.

II. The decision below conflicts with decisions of a state court of last resort.

The decision of the Ninth Circuit is clearly erroneous and unreasonable in its application of Arizona law. Moreover, its holding has broad, negative and recurring implications in the nationwide administration of bankruptcy law. In any case of knowing concealment and misrepresentation, albeit with no malicious intent, the lower court now appears to require only one test, a strict standard, which turns upon whether a debtor's state of mind contained an intent to commit "an actual fraud," which is "characterized by a willful intent to deceive," (App. A, at A-5 through A-7), before a court will release to its true owners property wrongfully obtained.

In its opinion, although acknowledging that it must look to state law in order to determine the nature of a property interest, the Ninth Circuit relied only upon the Arizona test

for "actual fraud," which it stated was "characterized by a willful intent to deceive." (App. A at A-6) It cited but one Arizona case, *Smith v. Pinner*, 68 Ariz. 115, 201 P.2d 741 (1949), *disapproved on other grounds, Marshall v. Superior Court, Maricopa County*, 131 Ariz. 379, 384, 641 P.2d 867, 872 (1982).

However, the Ninth Circuit failed to consider and apply the Arizona law of "constructive fraud," which law is similar to that of other jurisdictions, and which is equally necessary to any legal analysis as is that of "actual fraud." Thus, the Ninth Circuit opinion encourages bankruptcy courts and trustees to dismiss well-meaning but nonetheless harmful effects of knowing misrepresentations, when a debtor's state of mind does not disclose "deceptive intent" (App. A at A-6), ill-will or dishonesty. In other words, under the Ninth Circuit's rationale, a bankruptcy court may now regard, as property of an estate, any property which comes into the hands of the debtor through misrepresentations and falsehoods, so long as the elements of "actual fraud" have not been proven. Bankruptcy law and policy have never required such a strict and narrow application of fraud law, in determinations of what may constitute property of an estate. Nor is the test the only one for fraud. The Ninth Circuit, in relying *solely* upon the Arizona test for "actual" fraud, which is not a term of art but is an established theory of common law, has ignored its recent decision in *In re Cochise College Park, Inc.*, 703 F.2d 1339, 1359-60 (9th Cir. 1983), in which it recognized and applied the equally actionable Arizona law of "constructive" fraud. Under the latter test, constructive fraud occurs when one makes a false communication to another, without reasonable grounds for belief in its truth, which thereby induces justifiable reliance and ultimate damage, irrespective of the moral guilt or intent of the fraud feasor. *See Van Buren v. Pima Community College District Board*, 113 Ariz. 85, 87, 546 P.2d 821, 823 (1976); *Carrel v. Lux*, 101 Ariz. 430, 434, 420 P.2d 564, 568 (1966); *In re McDonnell's Estate*, 65 Ariz. 248, 252, 179 P.2d 238, 241

(1947); *Bell v. Bell*, 44 Ariz. 520, 539-40, 39 P.2d 629, 637 (1934).

Constructive fraud, as the Arizona Supreme Court stated in *Bell v. Bell*, 44 Ariz. at 539-40,

> . . . as contrasted to actual fraud, may be defined as a breach of legal or equitable duty which, irrespective of the moral guilt or intent of the fraud feasor, the law declares fraudulent, because of its tendency to deceive others, to violate public or private confidence, or to injure public interests . . . . Neither actual dishonesty of purpose nor intent to deceive is an essential element of constructive fraud, while they are essential in actual fraud.

However, the Ninth Circuit, by its failure to discuss and apply the state law of constructive fraud in the instant case, has now imposed upon litigants the strictest of standards in order to prove inequitable conduct, *i.e.*, only the debtor's state of mind:

> If the debtor believes in good faith that he will be able to carry out the transaction, he lacks the deceptive intent necessary for a finding of fraud. (App. A at A-6.)

The two-pronged "actual" or "constructive" fraud test is not unique to Arizona. It exists in numerous jurisdictions. *See, e.g., Hornaday v. First Nat'l Bank of Birmingham*, 259 Ala. 26, 65 S.2d 678 (1952); *United States Nat'l. Bank of Denver v. Bartges*, 122 Colo. 546, 224 P.2d 658 (1950), *cert. denied*, 340 U.S. 957 (1951); *Midtown Chains Hotel Co. v. Merriman*, 204 Ga. 71, 48 S.E.2d 831 (1948); *Regal Ins. Co. v. Summit Guaranty Corp.*, 324 N.W.2d 697 (Iowa, 1982); *General Electric Credit Corp. v. Wolverine Ins. Co.*, 420 Mich. 176, 362 N.W.2d 595 (1984); *Long v. Towne*, 98 Nev. 11, 639 P.2d 528 (1982); *Bernard v. Bernard*, 108 N.H. 360, 236 A.2d 685 (1967); *Snell v. Cornehl*, 81 N.M. 248, 466 P.2d 94 (1970); *Bank v. Board of Education of City of New York*, 305 N.Y. 119, 111 N.E.2d 238 (1953); *Phillips v. Ball*, 358 P.2d 193 (Okla. 1960); *La Course v. Kiesel*, 366 Pa. 385, 77 A.2d 877 (1951); *Archer v. Griffith*, 390 S.W.2d 735 (Tex.

1965); *Proctor Trust Co. v. Upper Valley Press, Inc.*, 137 Vt. 346, 405 A.2d 1221 (1979); *Stanley v. Sewell Coal Co.*, 285 S.E.2d 679 (W. Va. 1981).

Since constructive fraud is equally as destructive to innocent persons' rights as is actual fraud, and because it has frequently occurred in bankruptcy cases, and will happen again, the law should be firmly settled by this Court, consistent with its past rulings and those of other federal courts. It is extremely important to bankruptcy practice that this Court hold that property acquired by a debtor through its constructive fraud is beyond the "outer boundaries" of a bankruptcy estate. *See United States v. Whiting Pools*, 462 U.S. 198, 205 n.10 (1983).

CONCLUSION

Bankruptcy policy requires that bankruptcy courts, which are inherently courts of equity, *Katchen v. Landy*, 382 U.S. 323, 327 (1966); *Pepper v. Litton*, 308 U.S. 295, 304 (1939), not condone a bankruptcy trustee's use of another's property to pay general creditors' claims, when it was fraudulently obtained by the debtor. Nor should bankruptcy courts move cautiously when fraudulent conduct has occurred. Lower federal courts should fully understand and apply those standards enunciated by the Supreme Court, the federal courts and, when reference to state common law is involved, the highest courts of the states. A decision by this Court is of paramount importance to the administration of bankruptcy law throughout the United States, and will further define and give guidance upon recurring property issues contained within the scope of § 541 of the Bankruptcy Code.

It is, therefore, respectfully urged that this Court issue a writ of certiorari to the United States Court of Appeals for the Ninth Circuit to review its decision below, or, if appropriate, summarily reverse it.

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January, 1986

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Appendix A

IN THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

IN RE: NORTH AMERICAN COIN & CURRENCY, LTD.,

DEBTOR.

DANIEL A. TORRES, M.D., P.C. AND ARTHUR R. ROSE AND KATHLEEN ROSE, ET AL.,

PLAINTIFFS/APPELLANTS,

-vs-

HARRY V. EASTLICK, successor Trustee of North American Coin & Currency, Ltd., NORTH AMERICAN COIN & CURRENCY, LTD., An Arizona corp., JOHN DOES I through X, JANE DOES I through X, WHITE CORP., I through V,

DEFENDANTS/APPELLEES.

CA No. 84-1731
DC No. 83-2164

OPINION

Filed: August 6, 1985

Appeal from the United States District Court for the District of Arizona
Charles L. Hardy, District Judge, Presiding
Argued and Submitted December 12, 1984 - San Francisco, California

BEFORE: MERRILL, CANBY AND NORRIS, CIRCUIT JUDGES.

CANBY, CIRCUIT JUDGE:

North American Coin and Currency, Ltd. (hereinafter NAC or debtor) was an Arizona corporation in the business of buying and selling precious metals. The appellants are former customers of NAC who placed orders with the company and paid for them during the week of September 13, 1982, immediately before NAC filed for voluntary reorganization under Chapter 11 of the Bankruptcy Code. They brought this class action against the Bankruptcy Trustee, seeking to recover their funds from the bankruptcy estate. They claim that the trustee holds the funds in constructive trust for them because the debtor obtained the money by fraud or misrepresentation. On cross-motions for summary judgment, the bankruptcy court found for the trustee. The district court affirmed. We have jurisdiction over the appeal pursuant to 28 U.S.C. § 1291, and we affirm.

The parties agree that no genuine issues of material fact exist for purposes of review of the summary judgment in favor of the trustee. They characterize the facts differently, however, and they draw different inferences from those facts. We set forth the facts in the light most favorable to the plaintiff class, against whom summary judgment was granted. *See Ybarra v. Reno Thunderbird Mobile Home Village*, 723 F.2d 675 (9th Cir. 1984).

In the weeks prior to September 13, 1982, NAC suffered severe financial losses as a result of certain transactions initiated by the company president, Sherman Unkefer. On September 12, several men responsible for the daily operation of the company ("the principals") met to discuss the situation. [1] The NAC comptroller, David Weekly, who was

[1] Apparently none of these men was an officer or stockholder of NAC. David Weekly, the NAC comptroller, was the only one of the five who was a company employee. Three others were independent contractors; the fifth was an attorney who had handled some matters for the company but was not its general counsel. The fact that none of the actors was an officer or stockholder does not affect our analysis of this case, however, because the plaintiffs' claim is based on the alleged inequitable conduct of the company itself. Moreover, the company president accepted the course of action on which those at the meeting agreed.

present at the meeting, testified in deposition that the principals perceived ongoing mismanagement by Unkefer which was endangering the company's clients and employees. They believed that NAC was no longer operating soundly, and expressed doubts about the company's continued existence as a going concern. They perceived themselves as faced with two options. One choice was a mass resignation or disaffiliation, which in their view would have caused the immediate collapse of the company. The other choice was to operate the company for one more week in anticipation of a meeting of the NAC directors and stockholders the following weekend. The principals believed that the stockholders might infuse new capital into the company to keep it operating.

The principals chose to try to prevent the company from collapsing. They devised an emergency plan, which was carried out with Unkefer's approval. They created a bank account, labelled a "Special Trust Account," into which the company placed all receipts from new transactions during the week of September 13 through September 17. According to the company's lawyer, Joel Sacks, the purpose of the account was to protect new NAC customers in case the company did not survive. The trust account funds were not intended for use as operating money for the company. If the board of directors voted to keep the company alive, then the money was to be used to fill the customers' orders for precious metals in the regular course of business. If the company ceased operations, the principals anticipated that the customers would get their money back.

Between September 13, 1982, and September 20, 1982, the members of the plaintiff class placed nearly $600,000 worth of orders with NAC, and gave NAC the money to carry out the transactions. NAC deposited these funds into the "Special Trust Account" which had been set up at the North American Bank. The plaintiffs, however, never received the commodities that they ordered. NAC filed a Chapter 11 petition for reorganization on September 23, 1982. The funds in the "Special Trust Account" remain intact. The plaintiffs

now assert that the trustee for NAC holds those funds in constructive trust for them.

Property that is truly in trust is not "property of the [trustee's] estate" within the meaning of section 541 of the Bankruptcy Code, 11 U.S.C. § 541. Plaintiffs argue that the same result must follow for property that is subject to a constructive trust. They further contend that, because the existence and nature of the debtor's interests in property are determined by reference to state law, 4 *Collier on Bankruptcy*, § 541.02 (15th ed. 1979), they are entitled to all of the funds in the Special Account if Arizona law would view those funds as subject to a constructive trust.

While we agree that any constructive trust that is given effect must be a creature of Arizona law, we cannot accept the proposition that the bankruptcy estate is automatically deprived of any funds that state law might find subject to a constructive trust. We refuted that proposition in *In re Esgro, Inc.*, 645 F.2d 794, 797 (9th Cir. 1981) and *Elliott v. Bumb*, 356 F.2d 749, 753 (9th Cir.), *cert. denied*, 385 U.S. 829 (1966), where we held that, because of countervailing policies behind the Bankruptcy Act, state law could not be permitted to impose a trust on commingled property of a bankrupt's estate. A constructive trust is not the same kind of interest in property as a joint tenancy or a remainder. It is a remedy, flexibly fashioned in equity to provide relief where a balancing of interests in the context of a particular case seems to call for it. *See Raestle v. Whitson*, 119 Ariz. 524, 582 P.2d 170 (1978). Moreover, in the case presented here it is an inchoate remedy; we are not dealing with property that a state court decree has in the past placed under a constructive trust. We necessarily act very cautiously in exercising such a relatively undefined equitable power in favor of one group of potential creditors at the expense of other creditors, for ratable distribution among all creditors is one of the strongest policies behind the bankruptcy laws. *See In re Visiting Home Services, Inc.*, 643 F.2d 1356, 1360 (9th Cir. 1982); *Hassen v. Jonas*, 373 F.2d 880, 881 (9th Cir. 1967).

While state law must be applied in a manner consistent with federal bankruptcy law, *Johnson v. First National Bank of Montevideo, Minnesota*, 719 F. 2d 270 (8th Cir. 1983), *cert. denied*, 104 S.Ct. 1015 (1984), we do not suggest that it is irrelevant. Arizona law permits the imposition of a constructive trust "whenever title to property has been obtained through actual fraud, misrepresentation, concealment, undue influence, duress, or through any other means which render it unconscionable for the holder of legal title to retain and enjoy its beneficial interest." *In re Estate of Rose*, 108 Ariz. 101, 104, 493 P.2d 112, 115 (1972).

In permitting the imposition of a constructive trust for actions amounting to actual fraud, Arizona law is not inconsistent with federal bankruptcy law. Bankruptcy trustees have been held to have no interest in property acquired by fraud of bankrupts, as against the rightful owners of the property. *In re Flight Transportation Securities Litigation*, 730 F.2d 1128, 1136 (8th Cir. 1984), *cert. denied*, 105 S.Ct. 1169 (1985); *In re Paragon Securities Co.*, 589 F.2d 1240, 1242 (7th Cir. 1978); *Nicklaus v. Bank of Russellville*, 336 F.2d 144, 146 (8th Cir. 1964). The principle underlying this rule is that the creditors should not benefit from fraud at the expense of those who have been defrauded.

We do not find in this record, however, evidence to establish fraud. The plaintiffs do not contend, nor is there any evidence, that NAC committed any affirmative misrepresentations that induced them to do business with the company before it became insolvent. They were never promised that any special measures would be taken to protect their invest-

ments.[2] Rather, the plaintiffs' theory is that NAC committed a fraud simply by accepting new orders during the last week of its existence. The plaintiffs argue that NAC's managers took plaintiffs' money knowing that the company was insolvent and could not fill their orders. That conduct was fraudulent, the plaintiffs contend, because NAC did not reveal its dire financial trouble. Instead, the principals falsely held out the appearance of a viable operation in order to keep the company from collapsing.

We are not without guidance in determining when a transaction undertaken by a debtor shortly before insolvency amounts to a fraud on those with whom he deals. In Arizona, as elsewhere, "actual fraud" is characterized by a willful intent to deceive. *Smith v. Pinner*, 68 Ariz. 115, 201 P.2d 741 (1949). The debtor commits fraud, even though he has made no affirmative false representations, if he commits himself to a transaction with no intention of carrying it out. An intention not to carry out the transaction — in other words, a fraudulent intent — may be inferred where the debtor conceals his insolvency knowing that his financial situation is so hopeless that he can never meet the obligation he has acquired. *In re Paragon Securities Co.*, 589 F.2d 1240, 1244 (3d Cir. 1978); *Rochford v. New York Fruit Auction Corp.*, 116 F.2d 584, 585 (2d Cir. 1940). However, the debtor's mere failure to disclose his insolvency, without more, does not constitute a fraud entitling the creditor to rescind the transaction. *Id.* If the debtor believes in good faith that he will be able to carry out the transaction, he lacks the deceptive intent necessary for a finding of fraud.

---

[2] Indeed, a promise to create a trust for the benefit of certain creditors would probably be treated as a voidable preference under the Bankruptcy Code. No argument has been made in this case that the "Special Trust Account" creates an express trust for the benefit of the persons whose funds were placed in the account. Although the NAC principals may have intended that the plaintiffs would get their investments back if the company failed, that fact is irrelevant to the disbursement of the funds in bankruptcy.

We conclude that the evidence on which the plaintiffs rely does not support an inference that NAC intended to defraud them. Initially, our review of the evidence does not reveal any proof that the principals of NAC knew the company was insolvent when they met on September 12. The attorney Sacks testified that the people at the meeting primarily were concerned about whether NAC could cover its trading losses on the commodities markets quickly enough to prevent a loss of credit in future trades. Thus it is not clear that the principals considered the company insolvent. Moreover, even if we assume that the principals were aware of NAC's insolvency and did not reveal it, we cannot infer an intent not to complete subsequent commodities transactions from that fact alone. *See In re Paragon Securities Co.*, 589 F.2d at 1245. The plaintiffs also must show that when NAC accepted their orders, the company's managers did not believe in good faith that the company would survive. The record contains little support for such a conclusion. It reveals only that the NAC principals met to address the company's financial problems and decided to create the "Special Trust Account." The company closed its doors a week later. As was the court in *Paragon Securities*, we are unwilling to hold that the debtor here committed fraud as a matter of law by continuing to operate in the normal course of business prior to the time it decided to cease its operations. 589 F.2d at 1245. The fact that NAC adopted a plan to protect new customers in case the company failed does not, in itself, demonstrate that the principals believed the company could not meet its new obligations.

If anything, the evidence indicates that the people responsible for managing NAC acted in good faith. According to Weekly, the company comptroller, NAC's principals analogized their decision to a choice between blowing up a bridge and allowing those crossing the chasm to fall in, or allowing more people to try to cross even though "the bridge may crumble." The principals hoped that the shareholders would add new capital to the company to shore it up. Knowing that the future was uncertain, however, they also created the

"Special Trust Account." The new customers' money was not used to pay existing debts, as might be expected if the company accepted it with no intention of completing the customers' orders.

Our decision is not controlled by authority permitting customers of a bankrupt securities or commodities broker to retrieve funds remitted at a time when the business operations of the broker had already ceased. In *In re Vermont Real Estate Investment Trust*, 25 B.R. 813 (Bky., D. Vermont 1982), a real estate investment trust in the business of selling securities received a check for a securities purchase the day after the trustees had ordered the suspension of all trading in the trust's securities. The bankruptcy court held that the customer who sent the check was entitled to a full refund on a constructive trust theory. Similarly, in *In re Bengal Trading Corp.*, 12 B.R. 695 (Bky., S.D. Fla. 1981), the debtor was a commodities futures commission merchant who accepted funds for a securities purchase at a time when he could no longer legally trade in commodities futures because he did not meet the federal minimum financial requirements. Here too, the court held that the funds should be returned in full to the customer. Neither of these cases expressly relied on a fraud rationale, but they can be explained by the fact that the brokers involved either could not legally complete a requested transaction or clearly had no intention of doing so. In the instant case, by contrast, the customers who brought suit gave their funds to NAC at a time when the company was still conducting its business, albeit from a precarious position. As we have discussed, we cannot conclude from the circumstances surrounding NAC's operations that the company did not intend to complete the plaintiff's transactions. Indeed, the company clearly intended that if a new infusion of capital had occurred, plaintiffs' funds would have been put to the use for which they were remitted.

Plaintiffs' final contention is that, even if the circumstances do not amount to actual fraud, we should impose a

constructive trust on the ground that plaintiffs' funds were obtained by "means which render it unconscionable for the holder of legal title to retain and enjoy its beneficial interest." *In re Estate of Rose*, 108 Ariz. at 104, 493 P.2d at 115. For reasons of federal bankruptcy policy to which we have already referred, we are reluctant so to exercise a general equitable power in the circumstances here presented. We fully recognize that plaintiffs have sustained substantial losses as a result of the NAC bankruptcy. Plaintiffs, however, comprise only one of several comparable groups of creditors who sustained substantial losses. Plaintiffs happened to place their orders during the week of September 13, with the result that their funds were placed in a "trust" account (even though it was contemplated that the funds might later be removed to complete the transactions). Another group of customers placed their orders shortly before September 13, but sent in their purchase money during the week of September 13. Their funds were not placed in a special account, and they must look to the bankruptcy proceeding for their relief. Other customers both placed their orders and sent in their funds prior to September 13, but their orders had not been executed at the time of the bankruptcy. They, too, are treated as general creditors in the bankruptcy. We fail to discern the equitable principle that requires us to protect the plaintiffs' investments fully, at the expense of these other creditors. Indeed, the equities, as well as the principles underlying the bankruptcy laws, point in the other direction.

AFFIRMED.

Appendix B

IN THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

IN RE NORTH AMERICAN COIN AND CURRENCY, LTD.,

DEBTOR.

DANIEL A. TORRES, M.D., P.C., and ARTHUR R. ROSE and KATHLEEN ROSE, ET AL.,

Plaintiffs/Appellants,

-vs-

HARRY V. EASTLICK, Successor Trustee of North American Coin & Currency, Ltd., Debtor et al.,

Defendants/Appellees.

CA No. CA 84-1731

ORDER

BEFORE: MERRILL, CANBY & NORRIS, CIRCUIT JUDGES.

The following amendment is made to the last sentence of the first paragraph of this court's opinion in this case. "We have jurisdiction over the appeal pursuant to 28 U.S.C. § 1291, and we affirm" is modified to read "We affirm the judgment of the district court."

The panel, having amended the opinion, has voted unanimously to deny the petition for rehearing and suggestion for rehearing en banc.

The full court has been advised of the suggestion for rehearing en banc and no judge of the court has requested a vote to rehear the matter en banc.

The petition for rehearing is hereby denied and the suggestion for rehearing en banc is rejected.

Filed October 24, 1985

No. 85-1240

(2)

Supreme Court, U.S.
FILED
FEB 20 1986
JOSEPH F. SPANIOL, JR.
CLERK

In The

Supreme Court of the United States

October Term, 1985

DANIEL A. TORRES, M.D., P.C., et al.,
Petitioners,

v.

HARRY V. EASTLICK, Trustee of North American Coin & Currency, Ltd.,
Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

RESPONDENT'S BRIEF IN OPPOSITION

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No. 85-1240

In The

Supreme Court of the United States

October Term, 1985

DANIEL A. TORRES, M.D., P.C., et al.,
Petitioners,

v.

HARRY V. EASTLICK, Trustee of
North American Coin & Currency, Ltd.,
Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

RESPONDENT'S BRIEF IN OPPOSITION

Respondent respectfully requests that this Court deny the petition for a writ of certiorari, seeking review of the Ninth Circuit's opinion in this case.

STATEMENT OF THE CASE

Petitioners state (Petition ("Pet.") 5) that they agree with the facts as set forth by the United States Court of Appeals for the Ninth Circuit in its opinion. With one exception, described below, respondent accepts the Ninth Circuit's summary of facts as one made

"in the light most favorable to the plaintiff class . . ." (Petitioners' Appendix ("Pet. App.") A-2).

Respondent[1] does not accept petitioners' further characterization of, and conclusions drawn from, the facts as stated by the court of appeals. Petitioners contend (Pet. 6) that those facts show an intention to obtain money by "holding out" the appearance of a going concern, by not performing upon a representation that metals would be purchased, and by acting in a manner wholly inconsistent with the debtor's normal course of dealing, and that the debtor "falsely held out the appearance of a viable operation." None of the three courts which have considered this case has so found, and petitioners' contentions in this respect are merely argument.

The one respect in which respondent disagrees, for purposes of the Court's consideration of this petition, with the court of appeals' recitation of facts, is in that court's statement (Pet. App. A-3) that the company placed all receipts from new transactions during the week of September 13 through September 17 into the "Special Trust Account." In fact, those funds were deposited to the company's main depository account, together with all other receipts of the company. (Respondent's Appendix ("App.")).[2] Subsequently, checks in amounts equal to the amounts received from petitioners were written on the main depository account, and deposited to the "Special Trust Account." (App.).

REASONS FOR DENYING THE WRIT

The decision below neither conflicts with decisions of other federal courts of appeals on the same matter, nor with decisions of the Supreme Court of Arizona. The court of appeals, applying accepted principles of law to the distinctive facts of this case, reached a reasonable, permissible, and, indeed, correct, result.

---

[1]Respondent Harry V. Eastlick has, since his participation in the proceedings below, been discharged as trustee of North American Coin & Currency, Ltd., which now operates pursuant to an approved and confirmed plan of reorganization. North American has changed its name to Norcap Financial Corporation. Norcap has no parent companies, and no subsidiaries (other than wholly-owned subsidiaries) or affiliates.

[2]These facts are contained in the deposition of David B. Weekly, who was the company's controller. Pertinent portions of that deposition are reproduced in the Appendix to this brief.

1. THERE IS PRESENTED BY THE DECISION BELOW NO CONFLICT WITH DECISIONS OF OTHER FEDERAL COURTS OF APPEALS ON THE SAME MATTER.

Although petitioners contend that the decision below conflicts with decisions of other federal courts, a comparison of their statements of general principles (Pet. 8-10) with the opinion of the court of appeals does not reveal such conflicts. It is true that property of others, held by the debtor in trust at the time of the filing of the petition, is not a part of the debtor's estate. 11 U.S.C. § 541(a), (b); *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 205 n. 10 (1983). It is also true that neither the debtor nor its trustee has an interest in property acquired by the debtor's fraud, as against the rightful owners of the property. *In re Flight Transportation Corporation Securities Litigation*, 730 F.2d 1128, 1136 (8th Cir. 1984), *cert. denied sub nom. Reavis & McGrath v. Antinore*, ____ U.S. ____ 105 S. Ct. 1169 (1985); *In re Paragon Securities Company*, 589 F.2d 1240, 1242 (3rd Cir. 1978); *Nicklaus v. Bank of Russellville*, 336 F.2d 144, 146 (8th Cir. 1964). Petitioners and the court of appeals are in agreement as to both of these principles; the court of appeals found that no such fraud existed and, in fact, that "[i]f anything, the evidence indicates that the people responsible for managing NAC acted in good faith." (Pet. App. A-7).

Petitioners further argue that "actual" fraud is not a prerequisite to a finding that property is not properly a part of the bankruptcy estate, and that property obtained by "other tort," or by other "circumstances which make it inequitable that [the property] should be retained" (Pet. 9), will suffice. The court of appeals did not reject this possibility. It merely concluded that it would not exercise what is in fact its general equitable power to impose a constructive trust *"in the circumstances here presented"* (Pet. App. A-9) (emphasis added), and it examined those circumstances in considerable detail.

Petitioners' conclusory assertion that "[w]here an estate's property has been received through circumstances which make it inequitable that it should be retained by the one who holds only the legal title, courts will impose a constructive trust . . ." (Pet. 9), does not establish that such circumstances existed under the facts

of this case. As the court stated in *Gordon v. Spalding*, 268 F.2d 327, 331 (5th Cir. 1959), cited by petitioners (Pet. 9), "every transaction is judged by its own character and ingredients and acquires its legal status from these alone. . . ."

The several decisions of courts of appeals, cited by petitioners, illustrate the significance of such individual facts. In *Gordon v. Spalding*, 268 F.2d 327 (5th Cir. 1959), the court found that "[t]he Bankrupt committed a conversion and fraud. . . ." 268 F.2d at 329. Further, the court there did not need to consider other creditors' claims to a share of the same fund. In *In re N.S. Garrott & Sons*, 772 F.2d 462 (8th Cir. 1985), the claimed fund was held in escrow by a third party, and the court found that the money had been "obtained by the debtors through a very questionable scheme," by means of a commitment for title insurance "which debtors knew to contain false information." 772 F.2d at 466. In *In re Teltronics, Ltd.*, 649 F.2d 1236 (7th Cir. 1981) and *Nicklaus v. Bank of Russellville*, 336 F.2d 144 (8th Cir. 1964), there were, underlying the constructive trust determinations, criminal fraud convictions. In *In re Liebig*, 255 F. 458 (2nd Cir. 1918) there was a finding of a "preconceived intent not to pay." 255 F. at 463-464.[3]

As the courts in some cases have, based upon the "character and ingredients" therein, found the imposition of constructive trusts to be appropriate, courts in other cases have, based upon the "character and ingredients" of such cases, found to the contrary. *See, e.g., In re Daves*, 770 F.2d 1363 (5th Cir. 1985) (state law requirements for constructive trust not met); *In re Flight Transportation Corporation Securities Litigation*, 730 F.2d 1128 (8th Cir. 1984) (constructive trust claim not so strong as to make it an abuse

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[3]Petitioners also cite the decision of the Ninth Circuit in *In re Cochise College Park, Inc.*, 703 F.2d 1339 (9th Cir. 1983), asserting that the court, in this case, has ignored the decision in that case. First, petitioners' initial citation of the *Cochise College Park* case was contained in their petition for rehearing in the court of appeals. Second, the cited portion of that case dealt with the personal liability of a trustee in bankruptcy for his own misrepresentations, and not with the standards for the imposition of a constructive trust. Third, even if there were an inconsistency between these two decisions of the Ninth Circuit, that court is capable of resolving such inconsistency. *See Davis v. United States*, 417 U.S. 333 (1974).

of discretion to approve a settlement that roughly split claimed funds in half); *In re Esgro, Inc.*, 645 F.2d 794 (9th Cir. 1981) (no fraud or other wrongful act); *In re Kennedy & Cohen, Inc.*, 612 F.2d 963 (5th Cir. 1980) (no evidence that debtor knew it could not perform contracts); *In re Paragon Securities Company*, 589 F.2d 1240 (3rd Cir. 1978) (no fraud); *Dodge Motor Trucks, Inc. v. First National Bank of Omaha*, 519 F.2d 578 (8th Cir. 1975) (no evidence of fraud or absence of good faith).

"Broken promises and unfulfilled expectations do not alone give rise to trusts." *Manget Brothers, Inc. v. Bank of Greenwood, Mississippi*, 381 F.2d 91, 99 (5th Cir. 1967). Further, not only does "the mere failure of a party to disclose that he is insolvent . . . not constitute a fraud entitling the other party to rescind the sale," *In re Paragon Securities Company*, 589 F.2d at 1244, the fact is that no court has here found either knowledge of insolvency or an intent not to perform (Pet. App. A-7).

As were the other cases, both those cited by petitioners and those cited by respondent, this case was decided by application of generally accepted rules to a case having its own "character and ingredients."

2. THERE IS PRESENTED BY THE DECISION BELOW NO CONFLICT WITH DECISIONS OF THE SUPREME COURT OF ARIZONA.

Petitioners assert that "[a] debtor's interest in property is determined by looking to state law," although "the ultimate issue of whether the property belongs to the bankruptcy estate is a federal question." (Pet. 10). There is no dispute as to these propositions.

Petitioners contend, however, that the court of appeals failed "to fully consider applicable state law" (Pet. 10), by failing "to consider and apply the Arizona law of 'constructive fraud' . . ." (Pet. 11). That is not the case. As is clear from a review of the opinion of the court of appeals (Pet. App. A-8 to A-9), that court considered "[p]laintiffs' final contention . . . that, even if the circumstances do not amount to actual fraud, we should impose a constructive trust on the ground that plaintiffs' funds were obtained

by 'means which render it unconscionable for the holder of legal title to retain and enjoy its beneficial interest.''' (Pet. App. A-9). The court declined to require the imposition of a constructive trust, pursuant to that contention, ''in the circumstances here presented.'' (Pet. App. A-9).

That the court did not use the term ''constructive fraud'' in its analysis may be explained by the fact that petitioners, while asserting that a finding of actual fraud is not necessary for the imposition of a constructive trust, did not use the term ''constructive fraud'' in their briefs on appeal.[4] Petitioners did argue that the doctrine of constructive trust is a flexible one, quoting from *Raestle v. Whitson*, 119 Ariz. 524, 582 P.2d 170 (1978), wherein the Supreme Court of Arizona in turn quoted from Justice Cardozo: '' 'A court in equity in decreeing a constructive trust is bound by no unyielding formula. The equity of the transaction must shape the measure of relief.' '' 119 Ariz. at 526, 582 P.2d at 172, quoting from *Beatty v. Guggenheim Exploration Co.*, 225 N.Y. 380, 122 N.E. 378, 380-381 (1919).

The doctrine of constructive trust is indeed a flexible one under Arizona law. A constructive trust is an equitable remedy, *King v. Uhlmann*, 103 Ariz. 136, 144, 437 P.2d 928, 936 (1968); *Condos v. Felder*, 92 Ariz. 366, 368, 377 P.2d 305, 307 (1962), ''an instrument of equity for the maintenance of justice, good faith, and good conscience.'' *Honk v. Karlsson*, 80 Ariz. 30, 34, 292 P.2d 455, 457 (1956). While the forms and varieties of constructive trusts ''are practically without limit,'' nevertheless ''the element of fraud, either actual or implied, must always be present.'' *MacRae v. MacRae*, 37 Ariz. 307, 313, 294 P. 280, 282 (1930). Further, ''[p]roof of a constructive trust must be established by clear and convincing testimony.'' *King v. Uhlmann*, 103 Ariz. 136, 142, 437 P.2d 928, 934 (1968). *Accord, Smith v. Connor*, 87 Ariz. 6, 347 P.2d 568 (1959). Whether the '' 'evidence is sufficient to be clear

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[4]The term ''constructive fraud'' was first used by petitioners in their petition for rehearing, following briefing, argument, submission, and decision by the court of appeals. The term ''constructive fraud'' is used in respondent's brief in the court of appeals.

and convincing is primarily for the trial court.' " *King v. Uhlmann*, 103 Ariz. at 142, 437 P.2d at 934.

Petitioners cannot state that, under Arizona law, they would have been entitled, as a matter of right, to this discretionary, equitable remedy, even outside the bankruptcy context. Even less can they state that they would have been entitled to this remedy in bankruptcy, where its effect would be to prefer this group of customers over others, including others who paid money to the company, for similar transactions, at exactly the same time as did the plaintiffs. As the court of appeals held, there is no "equitable principle that requires us to protect the plaintiffs' investments fully, at the expense of these other creditors. Indeed, the equities, as well as the principles underlying the bankruptcy laws, point in the other direction." (Pet. App. A-9).

3. THERE EXISTS AN ALTERNATIVE GROUND OF DECISION, WHICH DOES NOT REQUIRE CONSIDERATION OF THE QUESTIONS PRESENTED BY PETITIONERS.

Even assuming that a court had concluded that the imposition of a constructive trust was an appropriate remedy in this case, no such remedy could be granted because the plaintiffs cannot trace their funds.

Under both Arizona and federal law, the imposition of a constructive trust on a fund of money is not appropriate unless the claimants' funds can be traced. *Korrick v. Robinson*, 20 Ariz. 323, 180 P. 446 (1919). *Accord, Johnson v. American National Insurance Company*, 126 Ariz. 219, 613 P.2d 1275 (App. 1980); *Barrasso v. First National Bank*, 122 Ariz. 469, 595 P.2d 1014 (App. 1979). *Rosenberg v. Collins*, 624 F.2d 659 (5th Cir. 1980); *In re Kennedy & Cohen, Inc.*, 612 F.2d 963 (5th Cir. 1980); *Elliott v. Bumb*, 356 F.2d 749 (9th Cir. 1966); *Sonnenschein v. Reliance Insurance Co.*, 353 F.2d 935 (2nd Cir. 1965).

Although the court of appeals stated that all receipts from petitioners' transactions were deposited to the "Special Trust Account," such was not the case. Petitioners' funds were deposited, along with all other funds received, to the debtor's main depository account, with equivalent amounts later transferred. Petitioners cannot trace their funds, or distinguish their funds from those of any

other creditor, including customers who paid money to the company at the same time as did petitioners.

Although courts have adopted various rules, based upon fictitious assumptions, governing the distribution of such commingled funds,[5] the rule which best accomplishes justice under the facts of this case is that followed in *Ruddle v. Moore*, 411 F.2d 718 (D.C. Cir. 1969), that is, a rule of equal distribution among all, "pro rata according to their respective losses." 411 F.2d at 718. Such a rule would provide to the petitioners herein compensation in a proportion no greater than that provided to other creditors, and that result has, in fact, been accomplished by the decision below.

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[5]*Compare Republic Supply Co. of California v. Richfield Oil Co. of California*, 79 F.2d 375 (9th Cir. 1935) ("lowest intermediate balance" test) *with Empire State Surety Co. v. Carroll County*, 194 F. 593 (8th Cir. 1912) ("first in, first out").

CONCLUSION

For the reasons set forth above, the petition for a writ of certiorari should be denied.

Respectfully submitted,

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APPENDIX

EXCERPTS FROM THE DEPOSITION OF DAVID B. WEEKLY

(January 27 and February 15, 1983)

"Q. Had the segregated account for customers' funds ever been used at North American Coin prior to September 13th, '82?

A. No. There was a trust account, but it wasn't really a segregated funds account, it was just labeled as such.

Q. What kind of money was put into that trust account?

A. All customer's [sic] funds coming in and out, disbursements and receipts were done from that account and posed [sic] to the general fund account." Page 108.

* * *

"A. That account has been used as the deposit account for all customers' receipts, retail and wholesale, for at least the last, the two years proceeding [sic] the bankruptcy that I am aware of.

Q. Does any other type of money go into that account?

A. All cash receipts go into that account." Page 126.

* * *

"Q. I take it you have it within your ability to trace those [class members'] transactions into that segregated account?

A. That was the purpose of the reports that were generated. You cannot trace, you cannot trace customer A's check into that account. You can trace customer A's check from the receipt to the deposit in the account that it was deposited into and then you can trace the transfer of funds from the account it was deposited into

into the segregated account." Page 51.

* * *

"THE WITNESS: If I recall the question correctly, whose funds were put in the account?

BY MR. LEHMAN:

Q. Yes.

A. The way I will answer this is how the funds were put into the account. To the best of my knowledge, no funds were deposited in that account on the 13th. What happened is a report was generated the evening of the 13th, which asked the computer to list those transactions which were entered into that day, for which receipts had been received. The receipts themselves were deposited into whichever bank was normally used to deposit those funds in, I don't recall, and the amount of the receipts that fell within the description I just gave you the next morning were transferred into this special segregated bank account." Pages 46-47.